METIS
GLOBAL PARTNERS

# METIS QUARTERLY INSIGHTS

2Q 2015

THIS ISSUE FEATURES



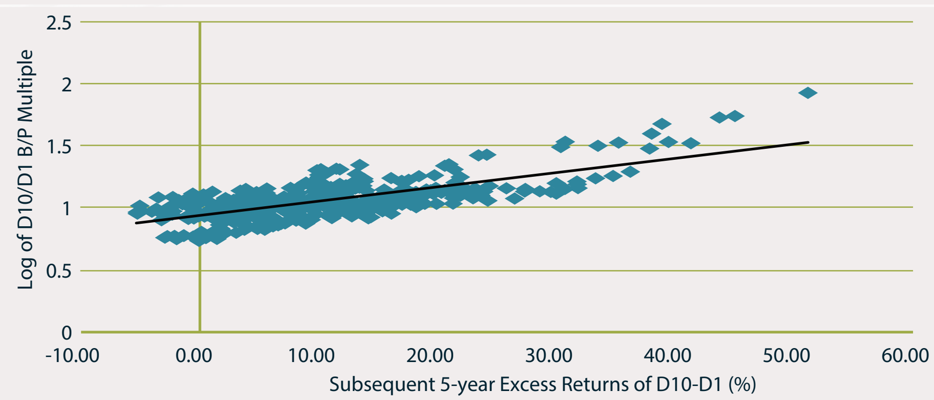
## GLOBAL OBSERVATIONS

### Disparity Is No Reason To Despair For Value Investors

Equity valuations strike us as increasingly bifurcated today. In fact, much of the world's stocks appear to be valued at one end of the spectrum or the other, with little in between. Bifurcated markets typically mean higher dispersion in valuations.

For value investors that can mean opportunity is knocking. The empirical evidence on valuation dispersion suggests it can be a fairly reliable predictor of future returns to value stocks. In a study conducted by our team and members of the Brandes Institute in 2009, high levels of valuation disparity (i.e. valuations of the cheapest decile relative to the most expensive decile) preceded periods of outsized excess returns to value stocks. This is a phenomenon well studied by academics and value investors including Cliff Asness and Rob Arnott to name a few.[1] Exhibit 1 demonstrates a statistically significant relationship between valuations of cheap and expensive stocks and subsequent returns in the U.S. since the late 1960s. "D10" represents the cheapest decile of stocks; "D1" the most expensive. Additional studies by the Institute confirmed this finding outside the U.S. as well.

**EXHIBIT 1: Valuation Dispersion and Value Stock Returns**
**P/B Ratio of Cheap vs. Expensive Stocks and Subsequent Excess Returns**
U.S. Stocks, April 30, 1968 – April 30, 2009




Source: The Brandes Institute, Value vs. Glamour Revisited: Historical P/B Ratio Disparities and Subsequent Value Stock Outperformance (September, 2009)

Valuation dispersion across global markets has steadily increased since the financial crisis to near-historical levels today. A recent report by Bernstein Research agrees, "valuation spreads based on price-to-book have been rising and are now at levels last seen in February, 2009."[2] Importantly, this trend in dispersion transcends geography, existing internationally and in emerging/frontier markets.

[1] Arnott, Robert D. and Li, Feifei and Sherrerd, Katrina F., Clairvoyant Value and the Growth/Value Cycle (April 8, 2009). Asness, C. and Friedman, J. and Krail, R. and Liew, J, Style Timing Value versus Growth (Spring 2000)

[2] Bernstein Quantitative Research: Quantitative Tools for Fundamental Investors – May 2015

**Exhibit 2: Valuations of Expensive and Cheap Stocks Globally**
Feb. 28, 1999 vs. April 30, 2015

| | Feb. 1999 | April 2015 |
|---|---|---|
| Most Expensive Decile | 13.50x | 13.04x |
| Market Median | 1.8x | 1.7x |
| Cheapest Decile | 0.63x | 0.58x |

Source: Worldscope via Clarifi, Metis as of 4/30/2015. Represents average P/B multiple of the cheapest and most expensive decile of stocks in market by P/B. Market represents the average price/book multiple of the largest 25% of stocks globally as measured by market capitalization.

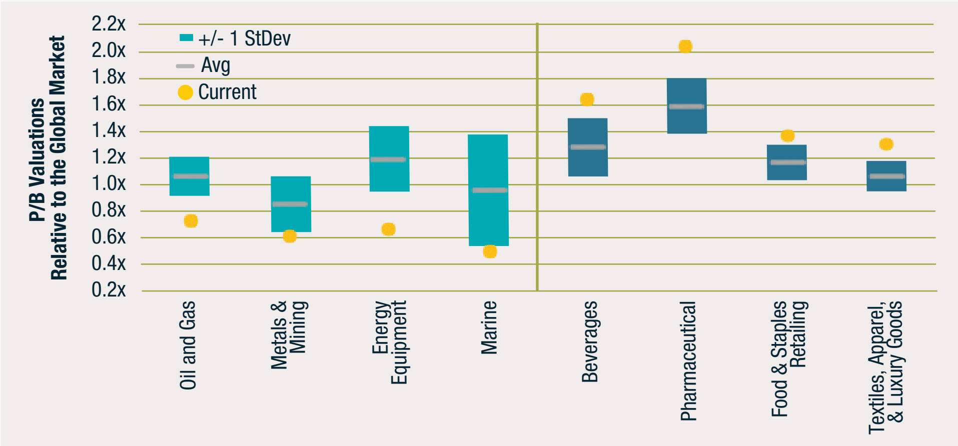
Much of this dispersion has been the result of investors paying increasingly higher prices for shares of highly-coveted businesses. The average P/B multiple for the most expensive decile of global companies expanded 53% in the last 5 years from 8.5x to 13.0x. Conversely, value stocks received little notice, as multiples increased a paltry 5% to 0.6x currently.

Valuation disparity reached all time highs during the peak of the TMT bubble in the early 2000s. Disparity in February, 1999, just 12 months prior to the market's peak, showed striking similarity to today (see Exhibit 2). While we are not suggesting that the markets are set for a repeat of post 2000, we would suggest that based on history, the factors illustrated in Exhibit 2 potentially bode well for value stocks. As Arnott noted in Clairvoyant Value, "the market subsequently rewards growth when Valuation Dispersion is unusually narrow and rewards value when Valuation Dispersion is wide, with good statistical significance."[1]

So what areas of the market contribute to today's bifurcation?

Regionally, there are areas like the U.S. and Europe where valuations are on balance relatively unattractive while companies in Japan, Canada, and select aspects of emerging markets still offer higher levels of disparity to the overall global valuation picture. However the most significant contributions to disparity are currently found across industry valuations. In the last Metis newsletter we focused on the historically low valuations of oil stocks. Even with oil prices reverting the past few months, oil and oil-related companies are still a meaningful contributor to disparity globally, remaining undervalued by historical standards. In other attractive areas, metals and mining as well as marine companies are valued about one standard deviation below normal and, given the number and geographic diversity in these industries, presents attractive opportunities regardless of mandate. On the contrary, pharmaceutical companies as well as a host of consumer areas including textiles and apparel, beverages, and food products companies look especially overvalued by historical norms (Exhibit 3).

**EXHIBIT 3: Select Over-/Undervalued Industries Relative to the Market**
January 31, 1990 - April 30, 2015




Source: Worldscope via Clarifi, Metis as of 4/30/2015. Represents average P/B multiple of the industry relative to the market. Market represents the largest 25% of stocks globally.

## METIS PORTFOLIOS

Positioning of our portfolios today reflects a number of these themes.

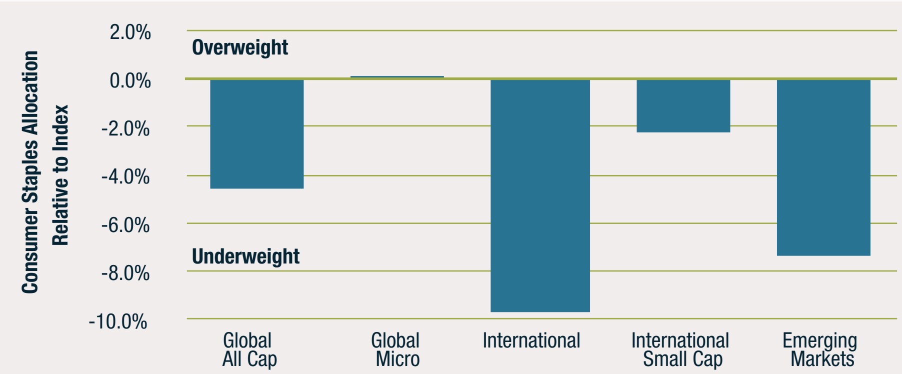
Oil has been a consistent overweight across our strategies since the second half of 2014 and recently a positive contributor to relative returns. From the perspective of historical, relative valuation, there is room for plenty of reversion in oil and energy companies. Our global and international strategies all have large allocations to Japan, though dispursed across a variety of industries. Japan is a market littered with companies valued near their net cash value (balance sheet cash less total debt), a topic for further discussion in our next newsletter.

The U.S. dollar's appreciation against most currencies is a prominent theme in the metals & mining industry where we are also overweight in many of our strategies. Commodity prices have historically been negatively correlated to the value of the U.S. dollar due to metals prices generally being quoted in USD, metals being produced globally, among other causes. Following the theme of disparity, some companies can potentially take advantage of this situation, while others can be adversely impacted. As noted by Bernstein research, "Companies with a primarily non-US cost base…enjoyed significant cost reduction due to the substantial depreciation of local currencies against the USD in 2014, which can more than offset the negative impact of lower commodity prices."

"The disparity theme also reflects where our portfolios are *not* currently positioned."

The disparity theme also reflects where our portfolios are *not* currently positioned. Our global strategies have been meaningfully underweight U.S. stocks for some time. These strategies, along with our international portfolios, currently find little value in Europe. Additionally, our emerging market portfolios have been underweight India, Taiwan, and Brazil in recent quarters. On a sector basis, we find few opportunities in consumer staples stocks, especially in beverages, food & staples retailing, and food products where valuations are especially elevated (Exhibit 4).

**EXHIBIT 4: Relative Weight in Consumer Staples by Metis Strategy**
As of April 30, 2015




Source: S&P, Metis as of 4/30/2015. Indices for each strategy are: Global All Cap, S&P Global BMI; Global Micro, S&P Global <$500 million Index; Int'l, S&P Global ex-U.S. LargeMid Cap Index; Int'l Small Cap, S&P Global ex-U.S. Small Cap Index; and Emerging Markets, S&P Emerging Markets LargeMid Cap Index. See endnote for full index definitions.

"Our contrarian eyes see the prospect of a compelling entrypoint for value-minded investors."

We believe bifurcated markets present an attractive opportunity for value investors. Historically, this type of environment has often preceded extended periods of value outperformance. Value stocks are currently priced as they were 5 years ago despite the broad market's rally, suggesting parts of the opportunity set may have been overlooked. Style returns reflect value investing being out-of-favor, as returns to growth indices have outperformed across markets, particularly during the past two years (Exhibit 5). Our contrarian eyes see the prospect of a compelling entry point for value-minded investors.

**Exhibit 5: Growth minus Value Returns in Global Markets**
S&P LargeMid Cap Indices by Region, as of March 31, 2015

| | U.S. | Developed Ex-U.S. | Emerging Markets |
|---|---|---|---|
| YTD | (3.40) | (1.36) | (2.39) |
| 1-yr. | (6.13) | (3.74) | (1.33) |
| 2-yr. Ann. | (3.77) | 1.10 | (3.80) |
| 3-yr. Ann. | 1.71 | 1.39 | (0.80) |
| 5-yr. Ann. | (0.58) | 0.12 | (0.49) |

Source: S&P via FactSet, as of 3/31/2015. U.S. represents the S&P United States LargeMid Cap Index, Developed ex-U.S. represents the S&P Developed ex-U.S. LargeMid Cap Index, and Emerging Markets represents the S&P Emerging Markets LargeMid Cap Index. See endnote for full index definitions.

**International Small Cap Demand**

*Intersec reports[6]:*

- $11B in *initial* fundings over the past three years.

- *Net* flows favor actively managed mandates ($12B received in the past 7 years).

The number of small caps in emerging/ frontier markets is greater than that of developed non-U.S. and U.S. markets combined.

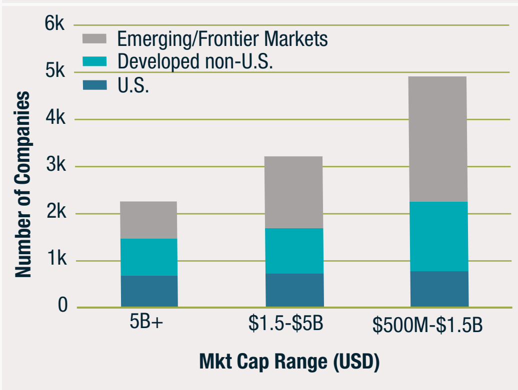
## STRATEGY SPOTLIGHT

### International Small Caps: It's A Big, Small World

Plan sponsors large and small are increasingly making commitments to small cap stocks in international markets.

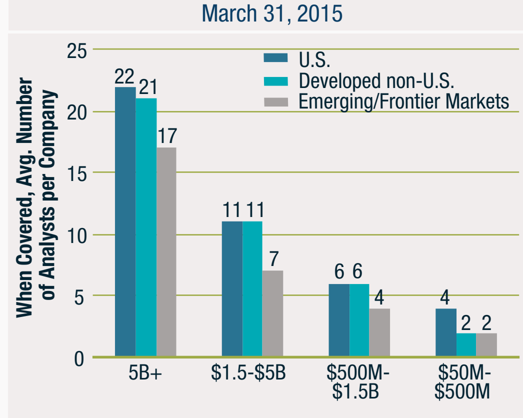
At Metis we believe that taking a global perspective is key to capturing the full opportunity set offered by international small caps. An approach we commonly see adopted by U.S.-based investors is that of a small cap 'EAFE' strategy that is inclusive only of companies located in developed countries outside the United States. Unbeknownst to some, this misses more than half of the opportunity set in international small caps. While there are indeed more small-cap companies in developed non-U.S. countries than in the U.S., the number pales in comparison to those domiciled in emerging/frontier markets (Exhibit 6).

**EXHIBIT 6: Number of Companies by Geography and Capitalization**
March 31, 2015




Source: CapitalIQ, Metis as of 4/30/2015.

**EXHIBIT 7: Sell-side Analyst Coverage by Geography and Capitalization**
March 31, 2015




Source: CapitalIQ, Metis as of 4/30/2015.

Moving down the market cap and out the geographic spectrum not only doubles the opportunity set, but also takes advantage of potentially inefficient segments of the international small cap market.

The benefits to an all-country approach don't end there. Investors also potentially benefit from exposure to coveted 'inefficiencies' or information arbitrage that is often a major draw to investing in international small caps. Using sell-side analyst coverage to proxy for efficiency, *in*efficiency increases as one moves down the market cap and out the geographic spectrum. Whereas 100% of U.S. large cap stocks have sell-side coverage, just 64% of small caps in emerging/frontier markets are covered. When they are covered, it's by just 4 analysts on average (Exhibit 7).

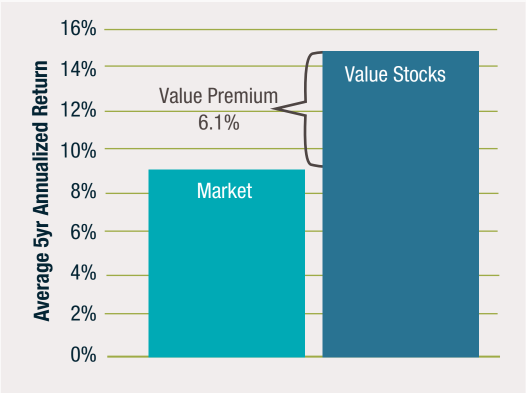
What about performance?

All-country international small caps also offered more attractive returns historically, particularly to a value investment approach. Over 5-yr holding periods, international small cap value stocks produced excess returns over the broad market of 610bps from 1990-2014, easily trumping that realized in U.S. markets (165bps). The value premium in emerging/frontier small caps was greater yet: 750bps (see Exhibits 8-9).

For all of these reasons, the Metis International Small Cap Portfolio seeks to maximize its opportunity set. We believe taking an all-country approach not only increases the probability of finding mispriced opportunities, but also allows the portfolio to tap into less-traveled geographies with larger value premiums historically.

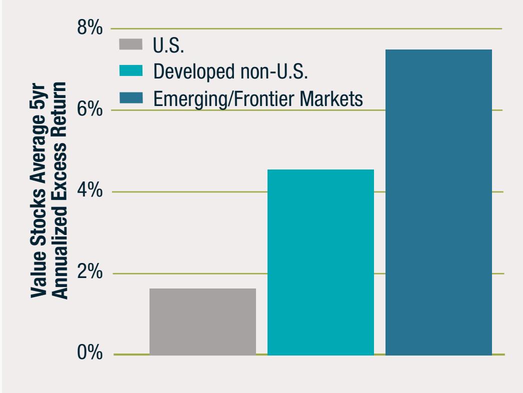
[6] InterSec Research, 2014 Year End Investment Industry Research Report of the U.S. Tax-Exempt Cross-Border Marketplace

**EXHIBIT 8: Annualized Returns of International Small Cap Stocks,** June 30, 1990 – June 30, 2014




Source: Worldscope via Clarifi, Metis as of 4/30/2015. Small cap market represents the largest 11%-25% of stocks globally outside the U.S. Value stocks defined as the cheapest decile of companies on a P/B basis, annually as of June 30th.

**EXHIBIT 9: Value Premium in Small Cap Stocks by Geography**
June 30, 1990 – June 30, 2014




Source: Worldscope via Clarifi, Metis as of 4/30/2015. Small cap market represents the largest 11%-25% of stocks globally outside the U.S. Value stocks defined as the cheapest decile of companies on a P/B basis, annually as of June 30th.

## METIS EQUITY STRATEGIES PERFORMANCE (THROUGH APRIL 30, 2015)

| | 3 Year | 2 Year | 1 Year | YTD 2015 | Apr. 2015 | Since Inception 7/29/2011 |
|---|---|---|---|---|---|---|
| **Global Micro Cap Equity (Gross)** | 11.34% | 8.15% | 0.81% | 6.51% | 5.62% | 7.63% |
| **Global Micro Cap Equity (Net)** | 9.97% | 6.82% | -0.44% | 6.07% | 5.51% | 6.30% |
| *Excess vs. S&P Global <$500M* | 0.89% | -1.13% | -3.03% | -0.42% | 1.81% | 1.78% |
| | 3 Year | 2 Year | 1 Year | YTD 2015 | Apr. 2015 | Since Inception 12/31/2013 |
| **International Small Cap Equity (Gross)** | -- | -- | 0.43% | 9.62% | 7.67% | 5.25% |
| **International Small Cap Equity (Net)** | -- | -- | -0.51% | 9.29% | 7.59% | 4.25% |
| *Excess vs.S&P Global ex-U.S. Small Cap* | -- | -- | -2.67% | -0.45% | 1.46% | 0.56% |
| | 3 Year | 2 Year | 1 Year | YTD 2015 | Apr. 2015 | Since Inception 12/31/2013 |
| **International Equity (Gross)** | -- | -- | -1.00% | 9.73% | 7.88% | 0.44% |
| **International Equity (Net)** | -- | -- | -1.75% | 9.46% | 7.81% | -0.33% |
| *Excess vs. S&P Global ex-U.S. LargeMid Cap* | -- | -- | -4.28% | 0.95% | 2.90% | -3.32% |
| | 3 Year | 2 Year | 1 Year | YTD 2015 | Apr. 2015 | Since Inception 6/30/2014 |
| **Emerging Markets Equity (Gross)** | -- | -- | -- | 12.57% | 11.60% | 1.91% |
| **Emerging Markets Equity (Net)** | -- | -- | -- | 12.24% | 11.52% | 1.15% |
| *Excess vs. S&P EM LargeMid Cap* | -- | -- | -- | 3.41% | 4.35% | -0.79% |

Metis Global Partners believes in the consistent application of valuation-driven decisions, free of behavioral biases, and grounded in the unique drivers of 60+ global industries

All strategies managed by Metis combine the best of both worlds: a fundamental, long-term value approach deployed in a systematic, bias-averse process.

"Understanding the behavior of overreaction is key to successful value investing..."

"Investors commonly embed into equity prices too great of an emphasis on recent news."

## THE BEHAVIORISTS' CORNER

Ever told someone close to you they are overreacting? Surely that worked out well. Nobody likes to be told they are overreacting, but everyone at some point does – it's embedded through human evolution. We sometimes act swiftly and emotionally only to regret it later, feeling we may have overreacted.

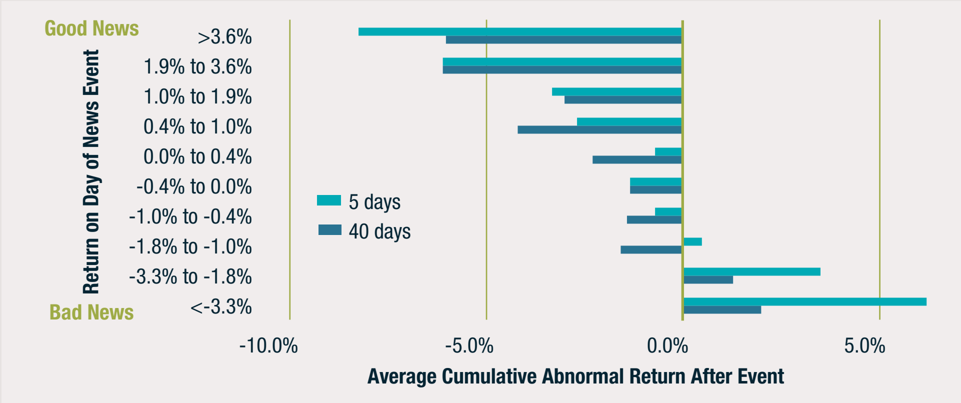
For better or worse, these emotions and reactions manifest themselves repeatedly in financial markets as well.

As long-term value investors, one of the more common behaviors we witness as a structural component of global equity markets is overreaction. Investors commonly embed into equity prices too great of an emphasis on recent news, events, and developments which, over a longer digestion period, are conceded to not have been nearly as significant. This behavior appears whether the news is good or bad and whether the news is company-, industry-, or market-specific.

We were reminded of this unshakable behavior upon reviewing Antweiler and Frank's study "News and Market Overreaction" that examined returns after a news event hit the market for a particular stock[3]. The authors deemed the news to be negative or positive based on the direction of the abnormal price move for the stock on the day the news broke. Upon tracking prices over the subsequent 40 days, their research attempts to document and measure the impact of investor overreaction.

Stocks that were impacted by negative news and had negative returns the day of the news release, outperformed in the days after the news broke. Conversely those stocks that received positive news and had positive returns on day one, subsequently underperformed on average after the news. Big news was followed by big reversals: stocks who received the worst news had the best subsequent returns (+6.2%) and those who received the best news had the worst subsequent returns (-8.2%). The price reversal revealed itself in as early as 5 days after the news broke, and persisted up to 40 days later. While the authors did not track performance beyond this window, other studies support the evidence of overreaction exceeding 40 days and lasting many years.[4]

**Exhibit 10: Average Abnormal Returns Subsequent to Good & Bad News**
An Analysis of Wall Street Journal News Stories from 1973 - 2001




Source: Metis reproduction of Table 4, Antweiler, W. and Murray, F., Do U.S. Stock Markets Typically Overreact to Corporate News Stories? (August 2006)

[3] Antweiler, W. and Frank, M., Do U.S. Stocks Typically Overreact to Corporate News Stories? (August 2006).

[4] See Dreman, D.; Lufkin, E; *Investor Overreaction: Evidence That Its Basis is Psychological,* The Journal of Psychology and Financial Markets, 2000, vol. 1, no. 1, 61-75 and De Bondt, W.; Thaler, R; *Does the Stock Market Overreact?,* The Journal of Finance, vol 40, no. 3, Jul. 1985, 793-805.

## THE BEHAVIORISTS' CORNER, CONTINUED

Overreaction transcends geography, as evidenced in research from our own team published in the Journal of Behavioral Finance, "The Role of Expectations in Value and Glamour Stock Returns"[5]. This research profiles the powerful extent of our overreactions. The study tracked subsequent 12-month performance of expensive and cheap stocks, further broken down by those stocks that beat or missed earnings targets during that same 12-month period. Naturally stock in companies that beat expectations outperformed those that missed, but what is perhaps unexpected occurred within value stocks.

While initial valuations of value stocks embedded market concerns, and even when that concern was seemingly validated by missed earnings targets, prices of value stocks rose. In fact, substituting other metrics for whether things improved/got worse for the companies (change in net margin, sales growth, improvement in book value, change in leverage, etc.) the exact same result occurred: prices for value stocks rose.

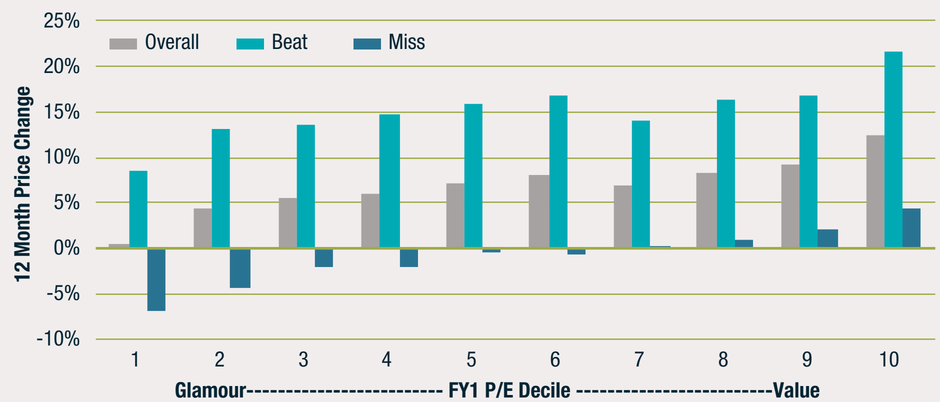
As noted in the paper, "the initial assessment of value stocks was mired in behavioral biases that pushed valuations to unwarranted lows. Subsequent price appreciation suggests a recognition (implicit or explicit) of earlier overreactions. Fundamentals needn't necessarily improve for prices to rise."

The take away from this edition of the Behaviorists' Corner: there is a reward to be earned for recognizing market overreactions and investing as contrarians with a patient, long-term investment horizon.

"Overreaction often equates to entry and exit point opportunity."

"Even when concern was seemingly validated by missed earnings targets, prices of value stocks rose."

**Exhibit 11: Average 12-month Price Change, Earnings Beats vs. Misses**
Developed Market Companies, June 30, 1990 – June 30, 2010




Source: Metis reproduction of Exhibit 11, Magnuson, N., The Role of Expectations in Value and Glamour Stock Returns, Journal of Behavioral Finance, 2011.

[5] Magnuson, N; *The Role of Expectations in Value and Glamour Stock Returns*, The Journal of Behavioral Finance, 2011, vol. 12, Iss. 2.

## The Metis Team

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## METIS: FIRM UPDATE

The spring of 2015 has been a productive time for the Metis Team. We kicked off the quarter by transitioning our advisor registration from state oversight to the SEC. Look for some exciting news to come next quarter on how we are going to use that new registration!

We were delighted to be a co-sponsor of the first Diverse Investor Forum- West, held at the Federal Reserve Bank in San Francisco on March 31st. This was an exclusive by-invitation only event for endowment, foundation and corporate investment professionals. In additional to Metis serving as a co-sponsor to this event, Machel Allen joined a panel of diverse managers with unique asset class domain knowledge to discuss how Metis' Emerging Markets Equity Strategy is generating alpha in the current market environment.

Metis in the News—Global Micro Cap was the topic du jour in the news this spring, with several media opportunities for the firm to discuss this exciting segment of the global markets. At www.metisgp.com you will find Metis highlighted in a March article of Money Management Intelligence that discusses why institutional investors should be looking at opportunities in the global micro-cap space. Additionally Machel was interviewed by financial news provider 'The Street', where she addressed the misconceptions of global micro-caps while building a solid case for them as a unique and attractive asset class. We are encouraged by the interest this space is garnering, and welcome opportunities to acquaint people with it.

To that end we also continued our collaborative research efforts with The Brandes Institute this quarter, completing a follow-on white paper that builds on our original co-published 'Introduction To Global Micro Cap: The Next Big Thing Could Be Really Small', September 2014. In this second piece, we focus on implementation strategy and considerations. Look for this paper to be released in the coming weeks.

Beyond the day-to-day management of the portfolios, the research team has focused much of its time this spring on our annual factor efficacy tests as well as reviewing improvements our data vendors have implemented over the last year. This work is all part of our ongoing commitment to bring to our clients' portfolios, the best information available. We look forward to updating you again soon on what is shaping up to look like a very exciting summer.

Patiently searching for value,

The Metis Team

INDEX DEFINITIONS

**S&P Developed ex-US LargeMid Cap Index:** The S&P Developed ex-US LargeMid Cap Index is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from developed markets excluding the United States.

**S&P United States LargeMid Cap Index:** The S&P United States LargeMid Cap Index is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from the United States.

**S&P Emerging Markets LargeMid Cap Index:** The S&P Emerging Markets LargeMid Cap Index is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from emerging markets.

**S&P Global Broad Market Index (BMI):** The S&P Emerging Markets LargeMid Cap Index is a comprehensive, rules-based index measuring stock market performance of small to large capitalization companies from in developed and emerging markets.

**S&P Global <$500 Million Index:** The S&P Global <$500M Index with net dividends is a comprehensive, rules-based index measuring stock market performance of micro and small capitalization companies from developed and emerging nations. It represents all issues in the S&P Global Broad Market Index whose market capitalization at time of index constitution is less than $500 million (USD).

**S&P Global ex-US LargeMid Cap Index:** The S&P Global ex-US LargeMid Cap Index is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from developed and emerging markets excluding the United States.

**S&P Global ex-US Small Cap Index:** The S&P Global ex-US Small Cap Index is a comprehensive, rules-based index measuring stock market performance of small capitalization companies from developed and emerging markets excluding the United States.

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